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Supreme Court of the United States

October Term, 1965

No. 252

Estate of LILLIAN VIRGINIA SPERLING, Deceased,
WARREN RICHARD SPERLING, Administrator,

Petitioner,

AGAINST

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITIONER'S REPLY BRIEF

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The Respondent's brief fails to meet the contentions made in the Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit in this case. In addition, Respondent has made certain errors as well as admissions and concessions which we would like to point out.

POINT I

The material facts in this case are admitted and conceded by the Respondent and are not in issue.

The Respondent in his brief has admitted and conceded the following facts:

> • The taxpayer was in the business of buying, selling, processing and refining precious metals (Resp. Br. p. 1).*

* All references are to the Respondent's brief, unless otherwise noted.

- The taxpayer herein maintained his books and filed his returns on the cash receipts and disbursements basis (p. 2).
- The taxpayer maintained inventories of his precious metals (p. 2).
- During the taxable years involved (1953 and 1954) a shortage of precious metals had created a black market (p. 2).
- Many of the taxpayer's suppliers insisted upon being paid in cash (p. 2).
- The difference between K & L's records and the taxpayer's records are attributable to the fact that K & L's records were kept on the accrual basis while the taxpayer's records were maintained on the cash receipts and disbursements basis (p. 3).

POINT II

The law is well settled that the accrual basis is mandatory in this case.

1. The Respondent argues that the Commissioner has discretion in taxing the taxpayer in this case, in spite of the improper accounting method, "because the possible additional revenue might not be worth the considerable effort that would be required" (pp. 3 and 4) to put the taxpayer on the accrual basis. There is no proof that the cash basis in this case was *ipso facto* beneficial to the taxpayer and detrimental to the Respondent.

2. Respondent argues further that the Petitioner has not claimed that the deficiency would be reduced if the accrual method were employed (p. 3).

While the Petitioner argues that he is not required to show that the deficiency would be reduced if the accrual method was employed, the Petitioner submits that he has shown by the examples set forth on pages 28 and 29 of the petition herein that this is nevertheless the fact.

The Respondent admits (p. 3) that "whenever a taxpayer maintains an inventory of goods, the accrual method of accounting provides the clearest picture of his taxable income from purchases and sales".

Then the Respondent says (p. 3):

> "Thus, *whenever possible,* he must utilize this method of accounting in filing his returns" (citing Treas. Regs. §1.446-1 (c) (2) (i)) (*Emphasis ours*).

However, Treas. Reg. §1.446-1 (c) (2) (i) is not optional, permissive or discretionary. *It is mandatory.* It provides:

> "*Special rules.* (i) In any case in which it is necessary to use an inventory the accrual method of accounting *must* be used with regard to purchases and sales unless otherwise authorized under subdivision (ii) of this subparagraph." (Emphasis ours.)

Subdivision (ii) however, does not authorize any other method of accounting in this case.

Accordingly the Regulations promulgated by the Respondent himself require the accrual basis in this case.

3. The Respondent also argues, as the Court below, that the Petitioner cannot oppose the Commissioner's determination simply by pointing to the taxpayer's improper accounting system, so long as the deficiencies are not themselves infected by the system's shortcomings (p. 4).

Throughout this case in all of the Courts, the Petitioner has pointed out that the cash basis is improper and that only the accrual basis will "clearly reflect the income" of the taxpayer in this case.

The Internal Revenue Code and the Regulations, and all the accounting authorities cited in the Appendix to Petition for Rehearing in the Court of Appeals, agree that the cash basis is improper and that only the accrual basis can clearly reflect income.

Under the circumstances, how could the deficiencies found by the Commissioner be more "infected", than when found on a cash basis system which admittedly does not reflect income! (See Treas. Reg. 1.446-1 (c) (2) (i) cited by the Respondent (p. 4) and the Court of Appeals (Pet. p. 42).)

Furthermore, Reg. 1.446-1(a) (2) which provides that "no method of accounting is acceptable, unless in the opinion of the Commissioner, it clearly reflects income", also prohibits the cash basis.

4. The Respondent argues further that the Regulations explicitly permit the Commissioner to authorize the taxpayer to use a method of accounting not specifically authorized by the Regulations, if income is clearly reflected by the use of such method (pp. 4, 5) or in the alternative the Commissioner may substitute another system of accounting if the latter more clearly reflects income (p. 5); but the Respondent ignores the fact that

the Code and his own Regulations provide that in a mercantile business, as here, where the purchase and sale of merchandise is an income producing factor, inventories must be maintained and in every case where inventories are maintained *only the accrual method of accounting "will clearly reflect income"*.

5. Next the Respondent makes the broad statement that the Commissioner has discretion in passing on a taxpayer's accounting method, and that the Courts will not overturn his decision, unless the evidence clearly shows an abuse of discretion, citing *Commissioner* v. *Hansen,* 360 U. S. 446, 467, and *Lucas* v. *American Code Co.,* 280 U. S. 445, 449.

Again, the Respondent ignores the fact that *he has already exercised his discretion* in promulgating Reg. 1.446-1 (c) (2) (i) making the accrual basis mandatory in this case.

Incidentally, neither the *Hansen* nor the *American Code Co.* cases stand for the proposition for which the Respondent has cited them.

Hansen was a case in which the taxpayer used the accrual method of accounting. The question there was whether retained percentage of installment paper were taxable under the accrual method of accounting. This Court held that it was.

Likewise in the *American Code Co.* case, the taxpayer's books were kept, and the returns filed, on the accrual basis. The question there was whether a judgment paid was deductible in one year or another.

In neither of these cases was there any exercise of discretion by the Respondent to make a determination contrary to his own regulations specifically providing for the point at issue.

6. Next the Respondent states that other Courts of Appeal have permitted the Commissioner to utilize the cash receipts method despite the fact that the taxpayer's income would have been more clearly reflected by the accrual method if the necessary information had been available (p. 5), citing *in re Newman*, 94 F. 2nd 108 (CA. 6) and *Greengard* v. *Commissioner*, 29 F. 2nd 502 (CA. 7).

In the *Newman* case the bankrupt (taxpayer) was found by the Court to be engaged solely in wrecking buildings and selling the salvage material. The taxpayer had no inventories and was not required to keep inventories under Sec. 471. He was not bound by Regulation 1.471-1 requiring inventories in which the purchase or sale of merchandise was an income producing factor, since the taxpayer did not purchase or sell merchandise as such. Consequently he was not bound to use the accrual basis under Regulation 1.446.1 (c) (2) (i), which is required in a mercantile case. There was no holding by the Court in that case that the taxpayer's income would have been more clearly reflected by the accrual method if the necessary information had been available. The Court found that the bankrupt did not keep books reflecting his actual income, whether on a cash receipts or disbursements or the accrual basis. The Court there said:

> "It was early recognized in the administration of the Income Tax Law that often *distortions of taxable income or net losses occurred by following the cash receipts and disbursements basis*, which resulted in heavy burdens on taxpayers in one year compared with another, and caused abnormal losses in taxes in the same manner to the Government. Beginning with the 1916 Law, the Taxing Act provided for optional methods of accounting in determining income; that is, either cash receipts or accrual." (Emphasis ours.)

In the *Greengard* case, when the taxpayer's books were offered in evidence without identification they were properly excluded upon objection. Then the petitioner offered proof by an accountant that he had examined the books of account from which he was prepared to offer his expert opinion that the books were kept on an accrual basis, and his opinion was held under the circumstances to be of no probative value.

The only other evidence was two exhibits: one, a statement by the Commissioner accompanying a tax determination, and the other, a Revenue Agent's field report in which it was stated that the taxpayer kept no books until after the examination was started by the agent.

Accordingly, the Court held that the taxpayer kept no books. This is no indication in this case that his income would have been more clearly reflected by the accrual method.

7. Next the Respondent says (p. 6) that while the taxpayer's method of accounting was improper, it would nevertheless "give the best available picture of the taxpayer's income." However, the Respondent overlooks the fact that under the law his income must not be *the best available under the circumstances* but must be determined by the accrual method of accounting.

8. Finally, the Respondent states that the burden is not on the Commissioner, but on the taxpayer to reconstruct his income, citing *Goodrich* v. *Commissioner*, 243 F. 2nd 686, 690-691 (C.A. 8), and *Schram* v. *U. S.*, 118 F. 2nd 541, 543-544 (C.A. 6) and states that the petitioner in the instant case made no effort to redetermine his income on the accrual basis (p. 6).

It is respectfully submitted that neither of the cases stand for the proposition for which the Respondent has cited them.

In the *Goodrich* case, the taxpayer changed from a hybrid method of part cash-part accrual to a strict accrual basis in 1949. The Court held that the Commissioner could not make an adjustment in the year of change without the taxpayer's consent.

It might be well to note what the Court there said on page 691:

> "A measure of discretion and flexibility is essential and inherent in practical tax administration, so long as it does not amount to *legal arbitrariness, unfair discrimination,* or a *violation of a statutory provision.*" (Emphasis ours.)

Here the Commissioner's determination amounts to all three: "legal arbitrariness, unfair discrimination and violation of a statutory provision".

The *Schram* case dealt with a bank, which is not subject to the rule of inventories and the necessity of maintaining its books on an accrual basis. The bank maintained its books on a hybrid basis, and claimed the right to change its method of accounting to a cash basis as to three categories of income and one of interest expense. We fail to see the connection of that case to the facts in the case at bar.

9. We submit that the opinion of the Court of Appeals in the last paragraph on page 42 of the Petition herein, wherein it cited the Code and Regulations, is decisive of the issue in this case, although the Court of Appeals decided to the contrary. In short, the Court

said that the Code and Regulations require the use of an accounting method which clearly reflects income; that where the purchase and sale of merchandise is an income producing factor, inventories must be taken into account; and that in any case in which inventories are necessary, the accrual method of accounting *must* be used with regard to purchases and sales.

This is the controlling law in this case, and yet the learned Court of Appeals has made a decision directly to the contrary.

Code Section 471 likewise requires inventories when necessary to clearly reflect income and regulation 1.471 (1) states that inventories are necessary in every case in which the purchase and sale of merchandise is an income producing factor.

10. The decision of the Court of Appeals below is directly contrary to the decision of this Court in the case of *Aluminum Castings Co.* v. *Routzahn,* 282 U. S. 92, in which this Court said at page 97:

> "* * * Experience demonstrating that income derived from merchandising and manufacturing businesses could not be computed on the basis of receipts and disbursements alone, treasury regulations were promulgated requiring the use of inventories in proper cases, and permitting the deduction of accounts payable when accounts receivable were brought into the income account * * *
> (98) '* * * *It is the purpose of the Act to require returns that clearly reflect taxable income*' * * * the return in every case is required to state such data as are 'appropriate and in the opinion of the Commissioner necessary to determine the correctness of the net income return and to carry out the

> provisions of this title'. It follows that *the return must be filed on the accrual basis under Sec. 13 (d), where true income cannot be arrived at on the basis of actual receipts and disbursements* * * * Any other construction of Sections 12 (a) and 13 (d) would disregard the requirement of Section 13 (b) and the dominating purpose of the Act, *by enabling the taxpayer to file a return which did not reflect true income.*" (Emphasis ours.)

As we stated, the decision of the Court of Appeals in this case is directly contrary to the *Aluminum Castings* case.

11. The opinion in the *Newman* case (*supra*), cited the case of *U. S.* v. *Tillinghast*, 69 F. 2d 718 (CA 1, 1934) in which the Court said on page 722:

> "The Commissioner's decision upon such questions" (valuation of stock and deductible loss) "is nearly conclusive, and, is final, unless shown to be unreasonable and unsupportable on any fair view of the facts. The burden on the objector is heavy, but in this case it cannot be said as a matter of law that the District Judge was not warranted in finding that the burden had been sustained (citations). In the latter case it was said:
>
> "While there is a presumption that the Commissioner's findings are correct * * * when it appears, as in this record it does appear, that the methods pursued by the Commissioner were mathematically and legally erroneous, that presumption no longer avails".

We submit that likewise in this case the decision of the Respondent herein, is unreasonable and unsupported on

any fair view of the facts and that the Petitioner has sustained his burden and the presumption that the Commissioner's findings are correct, no longer exists in this case, since it is shown that the method pursued by the Commissioner was mathematically and legally erroneous.

12. As to the contention that the Petitioner has made no effort to redetermine his income on the accrual basis (p. 6), while Petitioner submits he is not required to do so (as more fully set forth below), it is respectfully submitted that this was the whole point with regard to the testimony of the witnesses Cardiello and Silber and Exhibits 9 and 10 in the Tax Court regarding the K & L account (Appendix to Petitioner's Brief in the Court of Appeals).

The learned Court of Appeals below (Pet. p. 44) concedes the rule applicable to this case, that where a taxpayer establishes that the Commissioner's determination is erroneous, he need not also establish what is the correct determination (citing *Grubb* v. *Commissioner*, 315 F. 2d 753, 759, 6 Cir. 1963) but limited it to "cases in which the error infects the deficiency asserted by the Commissioner."

While we submit that we have already shown that the deficiency in this case is infected by the error which the Commissioner has made in determining a deficiency on the cash basis instead of the accrual basis, yet this Court in *Helvering* v. *Taylor*, 293 U. S. 507 (1935) made no such limitation.

There the Commissioner argued that the burden was on the taxpayer not only to prove that the Commissioner's determination was erroneous, but to show the correct amount of tax.

The Court said:

> "We find nothing in the statutes, the rules of the Board or our decisions that gives any support to the idea that the Commissioner's determination shown to be without rational foundation and excessive will be enforced unless the taxpayer proves he owes nothing or, if liable at all, shows the correct amount * * *.
>
> "Unquestionably, the burden of proof is on the taxpayer to show that the Commissioner's determination is invalid (citations). Frequently, if not quite generally, evidence adequate to overthrow the Commissioner's findings is also sufficient to show the correct amount, if any, that is due (citation). But, where as in this case the taxpayer's evidence shows the Commissioner's determination to be arbitrary and excessive, it may not reasonably be held that he is bound to pay a tax that confessedly he does not owe, unless his evidence was sufficient also to establish the correct amount that lawfully might be charged against him. On the facts shown by the taxpayer in this case, the Board should have held the apportionment arbitrary and the Commissioner's determination invalid."

We respectfully submit that the Commissioner's determination in this case is likewise arbitrary and invalid.

Conclusion

It is respectfully submitted that the Petitioner has shown that the accrual basis is mandatory in this case and the failure of the Commissioner to place the taxpayer on the accrual basis was erroneous and the Commissioner's

determination is arbitrary, erroneous and illegal and the decision of the Court of Appeals should be reversed as clearly erroneous.

It has been shown that the decision of the Court of Appeals below is directly in conflict with the decisions of this Court and with other decisions of the Court of Appeals for the Second Circuit, and other Circuits.

This case is representative of a problem confronting many taxpayers. The Internal Revenue Service has always, except in this case, taken the position that a taxpayer similarly situated must keep his books on an accrual basis in order to clearly reflect his income. It would be a gross miscarriage of justice to allow the decision of the Court of Appeals in this case to stand and to permit this taxpayer and other taxpayers similarly situated to be illegally and unfairly taxed.

For all of the foregoing reasons, it is respectfully submitted that the Petition for a Writ of Certiorari should be granted.

Respectfully submitted,

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END